Department of Finance

News Release

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Canada's New Government Improves Tax Fairness With Anti-Tax-Haven Initiative

The Honourable Jim Flaherty, Minister of Finance, today announced further details on the government's Anti-Tax-Haven Initiative set out in Budget 2007. The initiative focuses on improving tax fairness in Canada by preventing the use of tax havens and other means to avoid paying tax. Canada's current tax rules allow multinational corporations to avoid paying taxes by getting a double deduction for a single expense relating to a foreign investment.

"When multinational corporations use this tax loophole, Canadian taxpayers are indirectly subsidizing their international operations," said Minister Flaherty. "Our goal is to improve the fairness of our tax system and further reduce taxes for hard-working Canadians while preserving Canada's overall tax advantage for our globally successful companies."

The Anti-Tax-Haven Initiative will:

1) Prevent multinational corporations from using tax havens and other tax avoidance structures to generate two expense deductions for only one investment, so-called "double dipping";

2) Provide a transition period to 2012—after the planned reductions to the federal statutory corporate tax rate are fully phased-in and the rate has been reduced to 18.5 per cent;

3) Use tax revenues generated through the Anti-Tax-Haven Initiative to further reduce business taxes in Canada; and

4) Appoint an advisory panel of experts in the near future to look for ways to further improve the fairness and competitiveness of Canada's international tax system.

"We are providing corporate Canada with a transition period of almost five years to comply with these rules; we think this is fair and reasonable," said Minister Flaherty. "Implementation will take place once our planned corporate tax reductions are fully implemented, allowing us to make our strong competitive economy even stronger."

The Anti-Tax-Haven Initiative is consistent with *Advantage Canada*, the government's long-term economic plan for Canada. *Advantage Canada* is a plan to give Canada and Canadians the key advantages to be able to compete effectively and attract new growth and investment. They are:

- A Fiscal Advantage—Eliminating Canada's total government net debt in less than a generation;

- An Entrepreneurial Advantage—Reducing unnecessary regulation and red tape and increasing competition in the Canadian marketplace;

- A Knowledge Advantage—Creating the best-educated, most-skilled and most flexible workforce in the world;

- An Infrastructure Advantage—Building the modern bridges, roads and gateways we need to link our nation and make our workers and businesses more efficient; and

- A Tax Advantage—Reducing taxes for all Canadians and establishing the lowest tax rate on new business investment in the Group of Seven (G7).

Canada's New Government has made substantial tax reductions for business over the past 15 months, such as:

- Reducing the general corporate tax rate to 20.5 per cent in 2008 as part of our commitment to reduce this tax to 18.5 per cent by 2011;

- Eliminating the corporate surtax in 2008;

- Increasing the threshold for small business income eligible for the reduced federal tax rate from $300,000 to $400,000 in 2007;

- Reducing the 12-per-cent rate for eligible small business income to 11.5 per cent in 2008 and 11 per cent in 2009;

- Eliminating the federal capital tax in 2006;

- Providing incentives for the provinces to eliminate their capital taxes;

- Changing capital cost allowance rates to better align them with the useful life of assets; and

- Reaching an agreement in principle on the Canada-U.S. Tax Treaty that includes the elimination of withholding taxes on interest and the extension of treaty benefits to limited liability companies in Canada.

When fully implemented, these changes will move Canada from the third highest tax rate on new business investment in the G7 to the third lowest. The Government is committed to establishing the lowest tax rate on new business investment in the G7, and any revenue from this initiative will further that goal.

"The changes to the Income Tax Act required to give effect to the Anti-Tax-Haven Initiative will be complex and highly technical," said Minister Flaherty. "To ensure a comprehensive consideration of the factors involved and a smooth implementation, a Technical Roundtable of tax professionals, chaired by the Department of Finance, will be invited to work with government officials at a technical level to ensure that the proposal functions as intended. This Roundtable is a short-term project that will operate independently of the Expert Panel."

The attached backgrounder describes the Anti-Tax-Haven Initiative in more detail. Draft legislation to implement this initiative will be released for comment early this summer and will be introduced in the House of Commons in the fall. The government is determined to see this initiative passed into law as soon as possible.

For further information, media may contact:

Chisholm Pothier
Press Secretary
Office of the Minister of Finance
613-996-7861

David Gamble
Media Relations
Department of Finance
613-996-8080

www.fin.gc.ca

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Backgrounder

International Tax Avoidance and "Tax Havens"

In a fair tax system, everyone must pay their fair share of tax. Low-tax offshore jurisdictions—the so-called "tax havens"—play a role in facilitating international tax avoidance. Some low-tax jurisdictions are also tax havens in a less neutral sense, in that they encourage illegal tax evasion. These are jurisdictions that not only have low or no income taxes for non-resident investors, but also have secrecy laws in place to prevent other countries, such as Canada, from verifying whether their residents have invested there. The increasing mobility of global capital and the instantaneous distribution of information bring great rewards to open economies like Canada's. They also present some challenges, including the challenge of ensuring that business income is appropriately taxed. Multinational corporate groups use complex structures, often spanning several countries, in order to minimize their overall tax burden.

Increasingly, governments are recognizing that they must either act to limit the erosion of their domestic tax bases by creative international tax planners, or increase the share of taxes borne by their citizens and small businesses.

The international tax measures in Budget 2007 address both international tax avoidance and international tax evasion. Certain proposals in particular respond to multinational groups' use of low-tax jurisdictions and other avoidance structures as a means of obtaining two deductions for the same financing expense. (See Figure 1.) Where the low-tax jurisdiction has a tax treaty with Canada, these "double dip" structures allow a deduction in Canada as well as one abroad, with no Canadian tax payable ever by the Canadian corporation on its foreign investment income (since it is treated as "exempt surplus"). Where the low-tax jurisdiction is not a treaty partner, the structures produce a deduction in Canada with the income qualifying for indefinite deferral—that is, the income will be taxed only if and when the group decides to repatriate that income by paying a dividend from the foreign affiliate to its shareholder in Canada (as it is treated as "taxable surplus").

The proposals also respond to certain structures that do not use a "tax haven" or other low-tax jurisdiction. For example, complex "tower" structures seek to arbitrage differences between Canadian and U.S. tax rules to obtain the same result as the double dip. (See Figure 2.)

In addition, Budget 2007 sets out important initiatives to deal with the second concern with "tax havens"—secrecy laws in other jurisdictions that facilitate tax evasion in Canada. To detect and deter the concealment of income, the Canada Revenue Agency needs information from foreign governments. Canada will conclude no new tax treaty, nor update an existing tax treaty, unless the treaty partner country agrees to abide by the highest international standards of tax information exchange. Canada will also invite jurisdictions that are not candidates for full-scale tax treaties to enter into bilateral tax information exchange agreements (TIEAs).

A jurisdiction that has a functioning TIEA with Canada will gain an important competitive advantage: income earned there by the foreign affiliates of Canadian companies will be eligible for Canada's exempt surplus system. Income earned in a jurisdiction that has not

agreed to a TIEA, on the other hand, will be taxed in the hands of the Canadian parent company as the affiliate earns it. The scale of these consequences, both positive and negative, indicates how serious the Government of Canada is about dealing with international tax havens. Further evidence is the budget's significant enhancement of the resources of the Canada Revenue Agency specifically for international tax audit and enforcement.

The remainder of this backgrounder focuses on the budget proposals dealing with investments in foreign affiliates, as this is the most technically complex element of the international tax initiative. It should be kept in mind that those provisions are part of a larger package of international tax measures, which not only addresses international tax avoidance and evasion issues, but also simplifies and improves Canada's tax exemption for foreign-source business income and substantially reduces non-resident withholding taxes. Taken together, the package is a major advance in Canada's ongoing effort to balance competitiveness and fairness in the tax system.

International Taxation: The Canadian Experience

Since 1972, Canada has maintained a complex system for the taxation of the income that a corporation resident in Canada earns through a "foreign affiliate"—that is, through a non-resident corporation in which the resident person has a significant investment.

One aspect of this system is the tax exemption that Canada provides for dividends that a Canadian-resident corporation receives out of the active business income (for example, income from carrying on a manufacturing business) of its foreign affiliates in countries with which Canada has a tax treaty.

This "exempt surplus" treatment is a significant advantage for Canadian companies. Many other countries, including the United States, the United Kingdom and Japan, do not provide a comparable exemption. Instead, they tax their residents' foreign affiliate dividends, providing a credit for any foreign taxes paid on the underlying income. In any case where foreign tax rates are lower than home-country rates, Canada's exemption system is more generous than a credit-based system, since no Canadian tax is payable by the parent company when it receives the foreign earnings as dividends.

Canada also allows corporations to deduct, in computing for tax purposes their income from a business or a property, the expenses they have incurred to earn that income. Since shares are a source of property income (in the form of dividends), a corporation that buys shares with borrowed money can in most cases deduct the resulting interest expense. This includes shares that—because they are shares of a foreign affiliate in a tax-treaty country—may produce income that bears little or no tax overall, and no Canadian tax whatsoever in the hands of the affiliate's Canadian parent corporation.

The combination of Canada's tax exemption for foreign affiliate exempt surplus dividends, and the deductibility of interest expense on borrowed money used to acquire shares, thus creates a mismatch between income and expenses.

This mismatch offers distinct tax planning opportunities for multinational corporations. There has for many years been a question in tax policy circles as to the extent to which those opportunities are a legitimate and even necessary part of Canada's international competitiveness, and the extent to which they are an invitation to tax avoidance.

That question has no simple answer. Many would agree, though, that some of the tax planning structures that have been developed in response to Canada's international tax rules are inappropriate.

For example, many "double dip" structures have been used by multinationals to finance their investments abroad. Figure 1 shows a simplified example.

Figure 1: "Double Dip" Financing Structure - Example

Purpose: To finance Sourceco with debt (reducing or eliminating country S tax) *and* to obtain an extra interest deduction to shelter Canco's Canadian income from tax.

Method:

A Canco borrows from Bank.

B Canco contributes capital to Havenco.

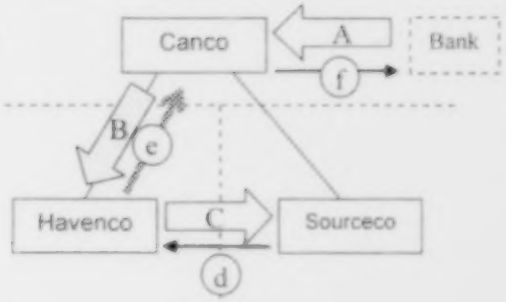
C Havenco lends to Sourceco.

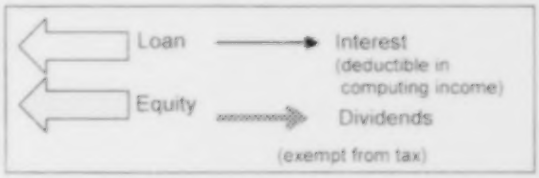
Tax effects:

d Sourceco deducts interest in country S (Havenco pays little or no tax on interest income).

e Havenco pays non-taxable dividends to Canco.

f Canco deducts interest.





Summary:

No tax payable in Canada (or country S, to extent of **d**) on Sourceco income.
Only tax paid is Havenco's low (or nil) local tax, net of any country S withholding tax.
Canco's deduction of **f** offsets Canadian tax on other income.

The interest deduction in Canada offsets the group's Canadian-source income, while another deduction, claimed in the country in which the business being financed is located (in the example, "country S"), shelters the structure from tax there. Taking advantage of another feature of Canada's rules, the group recharacterizes the resulting investment income as active business income, allowing it to be returned to Canada as exempt surplus dividends (and sometimes paid in turn to a foreign parent company). As a result, the group enjoys two deductions for what is economically the same expense. The extra deduction allows it to shelter other, Canadian-source income from Canadian tax.

Another class of tax avoidance techniques is generically known as "tower structures". Like double dips, these are chains of holding entities that are used to reduce or eliminate tax on investments from one country into another. The distinctive aspect of a tower structure is its exploitation of hybrid entities. A hybrid entity is one that is treated differently under the tax systems of two or more countries. For example, some entities that Canada recognizes

as corporations are seen by the United States as partnerships, and vice versa. Because corporations are subject to tax, while partnerships ordinarily are not (instead, their investors are generally taxed directly), a hybrid entity can allow a tax planner to ensure mismatching tax treatment as between the two countries. Figure 2 shows a simplified tower structure.

Figure 2: "Tower" Financing Structure - Example

Purpose: Finance U.S. Sub 2 with debt (reducing or eliminating U.S. tax) *and* obtain an extra interest deduction that can shelter Canadian income from tax.

Method:

G Borrowing to finance U.S. Sub 2 indirectly.

H Loan to U.S. Sub 2.

I, J Canada sees contributions of capital.

Tax effects:

k U.S. sees interest deduction by U.S. Co; Canada sees deduction by Canco (via partnership).

l U.S. Sub 2 deducts interest.

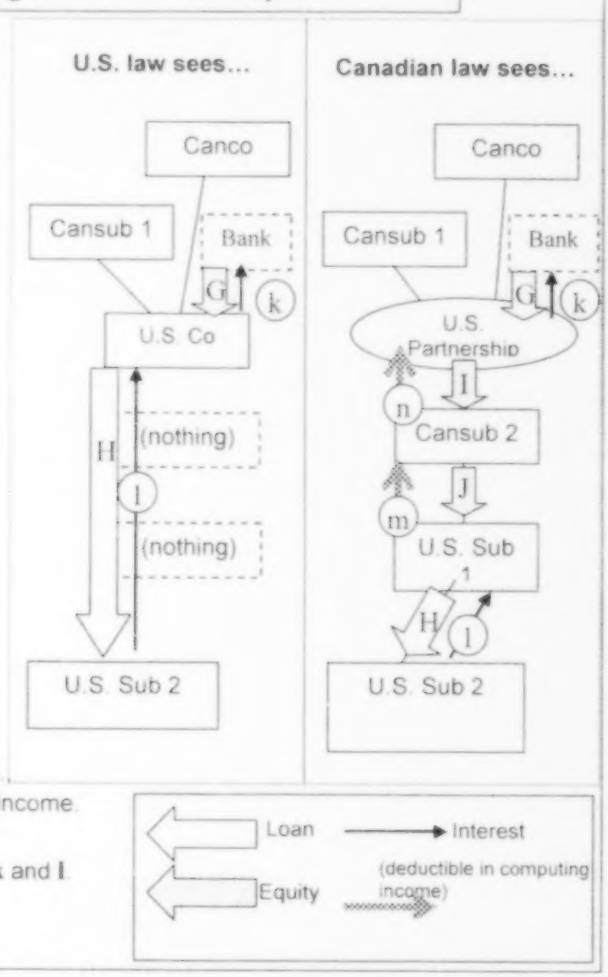
m,n Canada sees non-taxable dividends.

Summary:

No tax payable in Canada (or U.S., with deduction **l**) on U.S. Sub 2's income.

Only tax is U.S. tax on difference (if any) between rates of interest **k** and **l**.

Canco's deduction of **k** offsets Canadian tax on other income.



Both the double dip and the tower structure make investment outside Canada less costly than investment in Canada. Other things being equal, the mismatch between the interest deduction in Canada and the non-taxability of foreign-source earnings acts as an incentive to Canadian business to locate new operations—and the jobs they provide—in other countries, rather than in Canada.

Put differently, the "tax shield" provided by the extra deduction reduces the cost to a Canadian corporation of acquiring and operating foreign subsidiaries. Through that

deduction Canada is in effect subsidizing the expansion of multinational corporations, both foreign-owned and Canadian-owned, from bases in Canada.

Some could argue that these effects are desirable. Some might accept that these structures are inappropriate but nonetheless contend that Canada must tolerate them to help Canadian multinationals be internationally competitive. Canada's New Government disagrees.

To evaluate this contention, two points need to be considered: the extent to which other developed countries tolerate international tax avoidance by their residents; and the overall competitive position of the Canadian economy, including but not limited to its tax aspects.

International Tax Avoidance in Other Countries

Most of Canada's multinational corporations compete for international business with corporations that are resident in other major developed economies. A measure of a country's significance in this regard is the scale of its outward foreign direct investment (FDI): the amount of capital its resident firms invest in subsidiaries abroad. Countries with large outbound FDI include the United States, Germany, Japan, France and the United Kingdom.

These countries have tax systems that differ in important ways from Canada's and from one another. Nonetheless, all have in various ways attempted to control the extent to which international structures and operations can be used to shelter their income from domestic tax. The following outlines some of these initiatives.

United States: The U.S. has a number of rules that target tax avoidance strategies that generate double dips, including "dual consolidated loss" rules that prevent the same loss from being claimed in two jurisdictions, anti-hybrid rules that target certain structures used by foreign companies making U.S. acquisitions, and "limitation on benefit" provisions contained in many U.S. tax treaties.

Germany: As a substitute for limiting interest deductibility, the percentage of foreign business income that is exempt from tax is limited to 95 per cent. Proposed rules would limit total interest deductions (whether or not the interest was incurred to finance foreign direct investments) to 30 per cent of taxable income before interest.

Japan: In certain circumstances, special "tax haven" rules apply to recharacterize as Japanese-source income—and thus tax immediately—the income of a controlled foreign affiliate, if the affiliate's foreign tax rate is 25 per cent or less. As well, no credit for foreign taxes paid by a foreign affiliate is provided to the extent that foreign-source income exceeds 90 per cent of total income.

France: "Anti-tax-haven" rules specify that foreign business income will not be exempt when earned in a jurisdiction with a preferential tax treatment (i.e., a jurisdiction which imposes tax at less than two thirds the rate of tax in France). This would prevent firms from routing investments in third countries through a tax haven in order to achieve a double dip of interest expense.

United Kingdom: The UK has recently enacted anti-hybrid legislation which is aimed at "engineered" tax avoidance structures. This prevents firms from using structures that, for example, generate a deduction in a foreign jurisdiction, but no income inclusion for UK tax purposes. The UK is also considering a revision of its international tax system.

Overall Competitiveness: The Canadian Advantage

As noted above, a key argument advanced for tolerating double dips, tower structures and other forms of international tax avoidance is that Canada must compromise tax fairness in order to preserve the competitiveness of Canadian businesses. This supposes that a single factor, such as the ability to obtain double dip financing, can determine whether a company, or even an entire economy, is able to compete globally.

The Canadian Tax Advantage

International competitiveness is a function not of particular isolated aspects of a country's business environment, but of the economy as a whole. This is equally true of tax competitiveness: it can be assessed only by examining the overall impact of the tax system on business, investment, labour and quality of life, and comparing those to the equivalent impacts of tax systems elsewhere.

Competitiveness is central to this government's agenda. Last fall, the Government presented Canadians with *Advantage Canada*, a comprehensive plan to improve Canada's competitiveness. *Advantage Canada* makes clear that an overall business tax advantage is a vital part of this government's economic strategy.

The business tax advantage involves first, building an internationally competitive corporate tax system to attract and retain business investment; and second, eliminating tax-based distortions to business decision-making.

Since taking office, the Government has improved the competitiveness of the system in a number of ways, including:

- Reducing the general corporate tax rate to 20.5 per cent in 2008 as part of a commitment to reduce this tax to 18.5 per cent by 2011;
- Eliminating the corporate surtax in 2008;
- Increasing the threshold for small business income eligible for the reduced federal tax rate from $300,000 to $400,000 in 2007;
- Reducing the 12-per-cent rate for eligible small business income to 11.5 per cent in 2008 and 11 per cent in 2009;
- Eliminating the federal capital tax in 2006;
- Changing capital cost allowance rates to better align them with the useful life of assets;
- Providing incentives for the provinces to eliminate their capital taxes—in their most recent budgets, Quebec, Ontario and Manitoba have taken action to reduce their capital taxes; and
- Announcing agreement in principle with the United States on a major updating of the Canada-U.S. Tax Treaty.

Before the 2006 Budget, Canada's marginal effective tax rate (METR) was the third highest in the Group of Seven (G7). Taking into account the changes made to date, it will be the third lowest by 2011. The Government's objective, as stated in *Advantage Canada*, is to achieve the lowest METR in the G7.

The Anti-Tax-Haven Initiative will help maintain Canada's leading position, without sacrificing the principles of tax fairness that are also cornerstones of the Canadian approach. Tax fairness additionally ensures that overall tax rates can be lowered to benefit all Canadians.

The view of economic and business competitiveness is necessarily broader than the specific comparison of particular tax measures. In Canada, the Government has a standing commitment to an integrated, coherent approach to ensuring that the country's business environment ranks among the best in the world. This engagement was set out in the 2006 *Advantage Canada* plan. It includes a tax advantage. Even in terms of tax alone, the Canadian advantage goes well beyond the accommodation of specific tax planning structures.The international tax measures in Budget 2007 enhance both the fairness and the competitiveness of Canada's international tax rules. An important aspect of these proposals is that they address the tax avoidance structures described above. The Government also commits to use the revenues generated through the Anti-Tax-Haven Initiative to further reduce business taxes and increase competitiveness in Canada.

Details of the Budget Proposal

The Government is committed to shutting down inappropriate tax avoidance structures. At the same time, the modern economy does require that Canadian businesses be internationally competitive. To sustain competitiveness, Canada must have a tax system that, in its overall impact, is generally in step with the systems of major competing jurisdictions.

This need to balance tax fairness with competitiveness is reflected in the specific mechanism that is proposed to implement this part of Budget 2007's international tax package—a mechanism to prevent companies from obtaining two or more tax deductions for the same expense.

In broad terms, it is proposed that a deduction not be allowed in Canada in respect of interest relating to investments in foreign affiliates in those situations where the corporate group in question is entitled to deduct the same or an equivalent expense elsewhere. This addresses the double dip structure depicted in Figure 1 and resolves some other forms of tax avoidance such as the tower structure depicted in Figure 2.

An indicator of the duplication of a deductible expense is the recharacterization of the passive income of a foreign affiliate of the taxpayer, or of a foreign affiliate of a related person, as active business income, such that it can be returned to Canada as exempt surplus (or taxable surplus, if it was earned in a non-treaty country).

More specifically, it is proposed that interest on borrowed funds that a corporation resident in Canada uses to finance a foreign affiliate be non-deductible to the extent that any foreign affiliate that is a member of the same corporate group has interest income that has been recharacterized as active business income and that is traceable to the Canadian interest. Where the recharacterized income has borne foreign tax, the interest will be deductible in proportion to the foreign tax rate. That is, a grossed-up amount of the tax, representing the amount of income that would have generated that amount of tax had the foreign jurisdiction applied a Canadian tax rate, will continue to support deductibility in Canada.

The Government recognizes that this is a complex area of taxation. To ensure a comprehensive consideration of the factors involved and a smooth implementation, a Technical Roundtable of tax experts, chaired by the Department of Finance, will be created to provide input in the development of the enabling legislation. Tax professionals will be invited to work with government officials at a technical level to ensure that the proposal functions as it is intended. This Roundtable is a short-term, specific project that will operate independently of the Expert Panel.

The attached description sets out the operation of this proposal in more detail.

Transition

The Government proposes to make the measures described here applicable to interest payable on or after January 1, 2012.

No distinctions will be made under the transitional relief to transactions on or about Budget day, or based on arm's length versus non-arm's length debt. The transitional relief will thus provide almost five years for Canadian businesses to adjust to the new rules.

Expert Panel

Canada's international tax regime has important implications for Canadian-based businesses, as well as for the fairness and competitiveness of the tax system as a whole. These measures take important steps toward improving the international tax rules. But in a world where international business and investment are increasingly complex and rapidly evolving, it is essential that Canada's system keep pace. That is why the proposals include plans for an advisory panel of experts to undertake further study and consultations, with a view to building on the measures in the March 2007 budget, and identifying additional measures to improve the fairness and competitiveness of Canada's system of international taxation. The panel will be asked to produce an interim report by the end of 2007 and a final report in 2008.

An announcement will be made soon outlining the mandate and composition of the panel.

Technical Description of Mechanism to Implement the Anti-Tax-Haven Initiative to Constrain Inappropriate Tax Planning Structures to Finance Foreign Affiliates

It is proposed that the following mechanism, to implement the March 19, 2007, budget proposals concerning the deductibility of interest expense on debt used to finance foreign affiliates, replace the mechanism set out in paragraphs (24) to (29) of the Notice of Ways and Means Motion to Amend the Income Tax Act that was tabled with that budget.

International Taxation

(1) That, notwithstanding the general rules applicable to the deductibility of interest, no deduction be allowed in computing the income of a corporation for a taxation year for interest relating to investments in foreign affiliates that is paid or payable in respect of a period that begins after 2011, to the extent of the corporation's double dip income for the taxation year.

(2) That a corporation's interest relating to investments in foreign affiliates include the amount, if any, by which

(a) interest (and other borrowing costs) in respect of

(i) borrowed money that is used to acquire a share or indebtedness of, is used to lend to or to contribute to the capital of, or is otherwise used, directly or indirectly, for the purpose of earning income from, a corporation that is a foreign affiliate of the corporation or of a person or partnership that does not deal at arm's length with the corporation,

(ii) borrowed money that may reasonably be considered (having regard to all the facts and circumstances) to have been used to assist, directly or indirectly, a particular person or partnership with whom the corporation does not deal at arm's length, to acquire a share or indebtedness of, to lend to or to contribute to the capital of, or otherwise to earn income from, another corporation that is a foreign affiliate of

(A) the particular person or partnership, or

(B) another person or partnership that is related to the particular person or partnership or does not deal at arm's length with the corporation, and

(iii) an amount payable for property that is a share or indebtedness of, or other interest in, another corporation that is a foreign affiliate of the corporation, or of a person or partnership that does not deal at arm's length with the corporation,

exceeds

(b) interest received or receivable by the corporation in respect of indebtedness that is referred to in clause (a).

(3) That the "double dip income" of a corporation for a taxation year be the amount determined by the formula

A - B

where

A is the total of all amounts determined in respect of a share of the capital stock of a foreign affiliate that is owned by the corporation at any time in the taxation year each of which is a percentage of the recharacterized income of a foreign affiliate of the corporation, which percentage is equal to the share's participating percentage in respect of that foreign affiliate, and

B is the amount determined by the formula

C x D

where

C is the total of all amounts each of which is the amount of foreign income taxes that can reasonably be considered to have been paid in respect of an amount of recharacterized income of a foreign affiliate included in A, and

D is the corporation's relevant tax factor.

(4) That the "recharacterized income" of a foreign affiliate of a corporation be the total of all amounts each of which is that portion of an amount included under paragraph 95(2)(a) of the Act in computing the active business income of the foreign affiliate that is attributable to a specified debt owing to the foreign affiliate.

(5) That the "participating percentage" of a particular share owned by a corporation of the capital stock of another corporation in respect of a foreign affiliate of the corporation, in respect of the recharacterized income of the foreign affiliate, be determined in the same manner that the "participating percentage" of a particular share owned by the corporation of the capital stock of another corporation in respect of a controlled foreign affiliate of the corporation is, in respect of the foreign accrual property income of the controlled foreign affiliate, determined.

(6) That a "specified debt" owing to a foreign affiliate of a corporation be a debt owing to the foreign affiliate that arose as part of a series of transactions or events that included, and can reasonably be considered to have been funded by the proceeds of, indebtedness interest in respect of which is included in the interest relating to investments in foreign affiliates of the corporation or of a corporation that does not deal at arm's length with the corporation.

(7) That where, for any particular taxation year, the amount of a particular corporation's interest relating to investments in foreign affiliates exceeds the amount of the particular corporation's double dip income, and another corporation that was related to the particular corporation at any time in a taxation year of the other corporation that ends in the particular corporation's taxation year, has for that other corporation's taxation year double dip income that exceeds its interest relating to investments in foreign affiliates, the lesser of the other corporation's excess double dip income and the particular corporation's excess interest relating to investments in foreign affiliates be deemed to be double dip income of the particular corporation for the particular taxation year and not to be double dip income of the other corporation.

(8) That, where a non-resident corporation is considered to be a foreign affiliate of a partnership, the income of the partnership be determined in a manner consistent with the rules in paragraphs (1) to (7).

Notes for Remarks by the Honourable Jim Flaherty,

Minister of Finance,

to the Toronto Board of Trade

May 14, 2007

Check against delivery

Good morning.

I'm delighted to be here to talk about our plan to make a strong Canadian economy even stronger. A plan to create an environment that encourages investment, rewards hard work and further opens the doors for our investors, entrepreneurs and risk takers.

A plan to improve fairness in the Canadian tax system.

We have a great story to tell, and believe me, I tell it whenever I travel to international meetings such as the G7, the G8, the G20, APEC and IMF-World Bank.

Canadians have every reason to be proud. Our country is punching well above its weight, and the world is taking notice.

Our economic fundamentals are as solid as the Canadian Shield:

- We are experiencing the second longest period of economic expansion in Canadian history;

- Core inflation remains within our set range of 1 to 3 per cent;

- Our unemployment rate equals its lowest in 30 years, with more Canadians working than ever before; and

- We're on the best fiscal footing of any country in the G7. In fact, we are the only member of the G7 with ongoing budget surpluses and a falling debt burden.

Canada is also an emerging energy superpower:

- We have the second largest established petroleum reserves on the planet, next to Saudi Arabia;

- We rank third in global gas production;

- We are the world's largest producer of clean hydroelectric power; and

- We are also the world's largest producer of potash and uranium, the world's third largest producer of nickel, aluminum and diamonds, and the largest exporter of forest products.

Canadians are global leaders on many fronts, but we cannot afford to become complacent.

We need to set the pace. We need to reach further and go higher. We need to create a climate for further growth and greater prosperity.

Canada's New Government is doing just that.

We have moved the yardsticks further in 15 months than ever imagined. Historically, federal minority governments have had limited success in achieving their goals.

Not this government.

In March, our second budget was passed in the House of Commons. In Canada, a federal minority government hasn't had two consecutive budgets passed in 40 years, since Expo 67.

This demonstrates that we are indeed getting things done. We are:

- Reducing taxes significantly for individuals, families and business;
- Paying down the national mortgage by reducing our debt load by $22 billion over two years, or $700 for every man, woman and child in Canada;
- Dedicating all interest savings from the shrinking federal debt to personal income tax reductions—that's our Tax Back Guarantee, which is being legislated;
- Limiting the growth of spending;
- Balancing the books;
- Taking steps to strengthen the economic union by improving labour mobility within Canada and working with the provinces to establish a common securities regulator; and
- Taking significant steps to improve our environment. Last month my colleague, Environment Minister John Baird, announced a robust regulatory regime to reduce industrial greenhouse gas emissions. This regime is based on stringent targets that we will tighten every year. These industrial targets, combined with the previous environmental measures we are putting in place, will put us on the path to absolute reduction of Canada's greenhouse gases of 20 per cent by 2020. We believe this is a responsible approach that will not only improve our environment, but also ensure our economy can continue to grow and prosper.

To continue along an upward trajectory, we must be mindful of the various challenges that confront us:

- The significant rise in the Canadian dollar and its impact on our exports;
- Increased competition from emerging economic giants like China and India;
- The slowing of the U.S. housing market;
- A shortage of skilled workers; and

- An aging population.

Left unchecked, any of these could have a detrimental impact on the Canadian economy as a whole.

But we have an economic plan for Canada.

It's a plan that will lead to a more rewarding future for Canadians and their families.

It's a plan to give Canada and Canadians the key advantages to be able to compete effectively and attract new growth and investment.

It's a long-term economic plan called *Advantage Canada*.

Advantage Canada focuses on creating five key advantages:

- A Tax Advantage—Reducing taxes of all kinds and establishing the lowest tax rate on new business investment in the G7;

- A Fiscal Advantage—Eliminating Canada's total government net debt in less than a generation;

- An Entrepreneurial Advantage—Reducing unnecessary regulation and red tape and increasing competition in the Canadian marketplace;

- A Knowledge Advantage—Creating the best-educated, most-skilled and most flexible workforce in the world; and

- An Infrastructure Advantage—Building the modern bridges, roads and gateways we need to link our nation and make our workers and businesses more efficient.

I can assure you *Advantage Canada* will not become another document sitting on a shelf collecting dust. On March 19th I handed down our government's second budget, and it begins delivering on that vision.

For example:

We are making an historic investment in infrastructure—$33 billion over seven years for roads, bridges, water systems, public transit and international gateways. This is a monumental initiative to ensure we have the basic foundation of hard services to improve our productivity and competitiveness.

We are providing a major new accelerated capital cost allowance for manufacturers until the end of 2008, allowing them to write off their investments in equipment over two years to encourage new economic investment and to create jobs. This shot of adrenaline will help them adjust to the challenges I referred to earlier.

We are reducing the federal paper burden for businesses by 20 per cent and reducing the number of tax filings and remittances for more than 350,000 small businesses.

And we are increasing the lifetime capital gains exemption for Canada's 2 million small business owners to $750,000 from $500,000, the first increase in nearly 20 years.

As I mentioned earlier, one of the keys to long-term economic growth is tax relief.

Canadians pay far too much tax. They deserve to keep more of their hard-earned money. That's why Canada's New Government has provided relief in every way we collect taxes— consumption taxes, excise taxes, personal taxes and corporate taxes.

If we are to ease the tax burden even further, we need to ensure that everyone will pay their fair share. No special deals. No offshore tax haven advantages. No special treatment for the privileged few. Just lower taxes for all Canadians.

Tax fairness means paying your fair share. Regardless of whether you are an individual or a corporation. Regardless of the form a corporate entity chooses to assume. Regardless of whether a corporation chooses to use a tax haven.

Canadians understand that the essential services we provide, our health care, our education system and our social services, all cost money. Canadians are more than willing to shoulder their fair share of the cost. But Canadians, quite rightly, demand that the load be carried fairly by everyone—individuals, working families, small businesses and multinational corporations.

Last October, we took an historic step to improve the fairness of our tax system through the introduction of our Tax Fairness Plan. We levelled the playing field between corporations and income trusts, bringing Canada in line with other jurisdictions around the world.

In Budget 2007, we are taking tax fairness a step further with our Anti-Tax-Haven Initiative.

(slide 1)

As many of you know, this issue has been around for some time.

Concerns were expressed by the Auditor General, the 1997 Mintz Committee on Business Taxation, the House of Commons Public Accounts Committee in the 1990's and the House of Commons Finance Committee in 2006.

The Auditor General, in 1992 and 2002, recommended that the government review its rules and policies on the matter.

The 1997 Committee on Business Taxation recommended in its 1998 report that interest expenses of Canadian taxpayers paid on debt incurred to invest in foreign affiliates be disallowed.

We are following through on this advice.

(slide 2)

Our proposed Anti-Tax-Haven Initiative is composed of four specific parts:

- Firstly, preventing the use of double dipping and other tax avoidance schemes such as the "tower" structure, which I will talk about in a minute;

- Secondly, we are providing corporate Canada with a transition period of almost five years to comply with these rules. This means that implementation will take place only after our planned corporate tax reductions are fully in place, allowing us to make our strong competitive economy even stronger;

- Thirdly, any tax revenues generated through the Anti-Tax-Haven Initiative will be used to further reduce business taxes in Canada; and

- Finally, we will continue to look for ways to bring fairness to Canada's tax system. In the near future, we will be appointing an advisory panel of experts to look for ways to further improve the fairness and competitiveness of Canada's international tax system.

(slide 3)

Let me explain the kinds of tax planning I am talking about.

On this next slide, you will see a simplified illustration of a "single dip."

For example, a Canadian company, referred to here as Canco, has borrowed money from a bank to invest in a foreign affiliate and claims the interest as an expense against taxes.

The single dip provides a significant benefit to Canadian businesses investing abroad because the interest is deductible even though the related income from the investment is generally exempt from tax in Canada.

This treatment gives Canadian businesses a competitive edge when combined with other elements of Canada's tax system, such as competitive tax rates.

(slide 4)

The "double dip," seen here, is where we need to draw the line. It simply goes too far.

For example, Canco takes the borrowed funds noted above and makes an equity injection into Havenco, a company in a low-tax jurisdiction. Havenco then lends the funds to

Canco's affiliate in a third foreign jurisdiction, Opco, and Opco claims a second interest expense on those funds.

A "double dip" is a structure to finance investments abroad that, in short, allows two tax deductions for only one investment in a foreign affiliate.

Again, what we are talking about here is: one investment, some transfers of funds and two deductions.

Is this fair?

Is it fair for corporations to get two deductions to avoid paying tax?

Is it fair to ask hard-working Canadians to subsidize multinational corporations?

Is it fair to maintain a tax loophole that benefits some, but not others?

This is not what we call tax fairness in Canada.

This is inherently unfair.

(slide 5)

This next slide gives you an idea of the lengths some are willing to go to avoid paying tax. This is the "tower" structure I mentioned earlier.

The details are quite complex, but essentially this achieves the same result as the double dip transaction because Canada treats the U.S. partnership as a partnership and the interest paid by the partnership as an expense deductible by the Canadian partners, whereas the U.S. treats the U.S. partnership as a corporation and allows the interest paid by it to be deducted against U.S. investments.

There is a real investment at the bottom of the chain, but only one. The different characterizations of the transactions mean that the corporate group has managed to deduct the cost of financing that investment twice, once in the U.S. and a second time in Canada.

Again, this is inherently unfair.

Now some believe that by preventing the use of tax havens and other tax avoidance measures, we will be putting Canada at a disadvantage, that we will lessen the international competitiveness of our multinationals because the practice is allowed in other jurisdictions.

I do not agree.

(slide 6)

International competitiveness depends not on a particular isolated aspect of a country's business environment, but on the economy as a whole. This is equally true of tax competitiveness, which depends on many factors including marginal effective tax rates, statutory tax rates, taxation of foreign-source income, and interest deductibility.

(slide 7)

Canada compares well to other countries. Some limit double dipping—for example, the U.K. has taken important steps against certain forms of double dip transactions in recent years; some impose higher tax rates, like the U.S. and Japan; some tax repatriated foreign earnings—again the U.K. is in this category; and some restrict interest deductibility, such as Australia. Importantly, overall, Canada's tax system is competitive.

In fact, if we were to compare our tax system to the U.S. tax system, Canada's is more favourable in many important respects: the U.S. has higher tax rates; the U.S. taxes foreign earnings when repatriated; and the U.S. has been aggressive in shutting down tax avoidance, including, but not limited to, certain double dip structures.

(slide 8)

Some people believe that our Anti-Tax-Haven Initiative will contribute to the so-called "hollowing out" of corporate Canada. Several reports issued lately suggest this is not the case.

The Institute for Competitiveness & Prosperity has looked at hollowing out and says in its latest report:

> "We now have 72—or more than twice as many global leaders as in 1985. In fact, we are growing globally competitive Canadian firms at a rate that wildly exceeds the rate of foreign acquisition. Net, we simply are not being hollowed out. We are thickening up."

(slide 9)

Statistics Canada reports that there was a greater increase in Canadian investment abroad relative to foreign investment here. At the end of last year, Canadians' foreign corporate holdings were worth $74 billion more than foreign corporate holdings here, up from $52 billion more a year earlier.

In its fourth-quarter 2006 report, the Crosbie investment banking firm said "Canadian companies continued to exhibit a strong appetite for foreign companies, making 456 purchases valued at $70 billion, nearly quadruple the number of foreign acquisitions of domestic companies."

A KPMG report released last week says there have been more Canadian acquisitions of foreign firms than foreign acquisitions of Canadian firms over each of the past two years.

There is a considerable body of evidence pointing to the fact that Canada is a strong competitor in the vastly expanding global economy. Nevertheless, the Minister of Industry, Maxime Bernier, will soon be launching a competitiveness panel that will be studying a variety of areas, including "hollowing out." I look forward to reviewing their findings.

(slide 10)

We are also ensuring tax fairness will not compromise our competitive advantage in the world. The fact is that we have moved quickly to improve our competitive environment by lowering corporate taxes substantially.

- We are reducing the general corporate income tax rate to 20.5 per cent in 2008 as part of our commitment to reduce this tax to 18.5 per cent by 2011;

- We are eliminating the corporate surtax in 2008;

- We increased the threshold for small business income eligible for the reduced federal tax rate from $300,000 to $400,000 as of 2007;

- We are reducing the 12-per-cent rate for eligible small business income to 11.5 per cent in 2008 and 11 per cent in 2009;

(slide 11)

- We eliminated the federal capital tax in 2006;

- We are providing incentives for the provinces to eliminate their capital taxes—in their most recent budgets, Quebec, Ontario and Manitoba have taken action to reduce their capital taxes;

- We are better aligning capital cost allowance rates with the useful life of assets; and

- We have reached an agreement in principle on the Canada-U.S. Tax Treaty that includes the elimination of withholding taxes on interest and the extension of treaty benefits to limited liability companies in Canada.

(slide 12)

Through our two budgets and our Tax Fairness Plan, we have also provided significant, positive tax relief for individuals, families, students and seniors—almost $38 billion over three fiscal years. For example:

- We reduced the GST from 7 to 6 per cent;

- We introduced a Canada Employment Credit to help offset the cost of working;

- We are providing a new $2,000 child tax credit for each child under 18;

- We are introducing a Working Income Tax Benefit to help low-income Canadians over the welfare wall; and

- We introduced income splitting for pensioners and seniors.

(slide 13)

We are beginning to realize the benefits of our actions. As noted in this graph, when fully implemented, our changes will move Canada from the third highest tax rate on new business investment in the G7 to the third lowest by 2011.

Quite an accomplishment in just over a year, but we won't be satisfied until Canada's effective tax rate on new business investment is the lowest in the G7.

By maintaining our determination and focus we will reach our goal, but not at the expense of tax fairness.

(Tax Fairness Cover Slide)

We are proceeding with our Anti-Tax-Haven Initiative because it is the right thing to do, but we must ensure we get it right. As I said previously, the principle is sound and will be adopted. Implementation is something our tax experts are open to discuss.

The changes to the Income Tax Act required to give effect to the Anti-Tax-Haven Initiative will be complex and highly technical. To ensure a comprehensive consideration of the factors involved and a smooth implementation, a Technical Roundtable of tax experts, chaired by the Department of Finance, will be created to provide input in the development of the enabling legislation.

We will introduce legislation in the fall and will make every effort to get it passed into law as soon as possible. As I mentioned earlier, our track record in the House of Commons is pretty good, having passed two budgets.

I have now gone on for almost as long as it seems. Let me conclude with a few final thoughts.

Our Anti-Tax-Haven Initiative is part of our overarching goal to improve Canada's tax system. To ensure that everyone pays their fair share, so we can continue to lower taxes for the benefit of all Canadians.

I understand that there is some apprehension. If tax fairness were easy, these measures would have been adopted by the previous government long ago in the wake of reports by the Auditor General and the 1997 Committee on Business Taxation.

Fairness is one of the cornerstones of our Canadian value system. It is not something to be compromised, dismissed or conveniently ignored.

My commitment to tax fairness is unwavering. I will not back down from my commitment to protect hard-working taxpayers.

We started down the road to tax fairness with our Tax Fairness Plan, and our Anti-Tax-Haven Initiative is the next step. Again, our initiative focuses on:

- Preventing the use of double dipping and other tax avoidance schemes;
- Providing corporate Canada with a five-year transition period to comply with the new rules;
- Investing any tax revenues generated to further reduce business taxes in Canada; and
- Appointing an advisory panel of experts to look for ways to further improve the fairness and competitiveness of Canada's international tax system.

This approach is fair and reasonable. It treats individuals, families and multinational corporations equally.

You know, most Canadians get up every morning and go to work. They pay taxes and put a little money aside to try and get ahead. But according to the Fraser Institute, the first six months of every year is spent working for the government. Tax freedom day isn't until mid-June

We can and we must do better. If we broaden the tax base, we will be able to provide lower tax rates for all Canadians.

As Minister of Finance, I am committed to ensuring tax fairness and reducing the tax burden on hard-working Canadians. By adopting our Anti-Tax-Haven Initiative, we will be able to maintain and preserve confidence and integrity in our tax system. And that's imperative.

By working together and staying the course, we can achieve our goal of making Canada less taxing for individuals, working families and business.

Thank you for allowing me to be with you today.

Tax Fairness

Presentation to the Toronto Board of Trade
The Honourable Jim Flaherty
Minister of Finance
May 14, 2007

Tax Fairness: The next step

Anti-Tax Haven Initiative

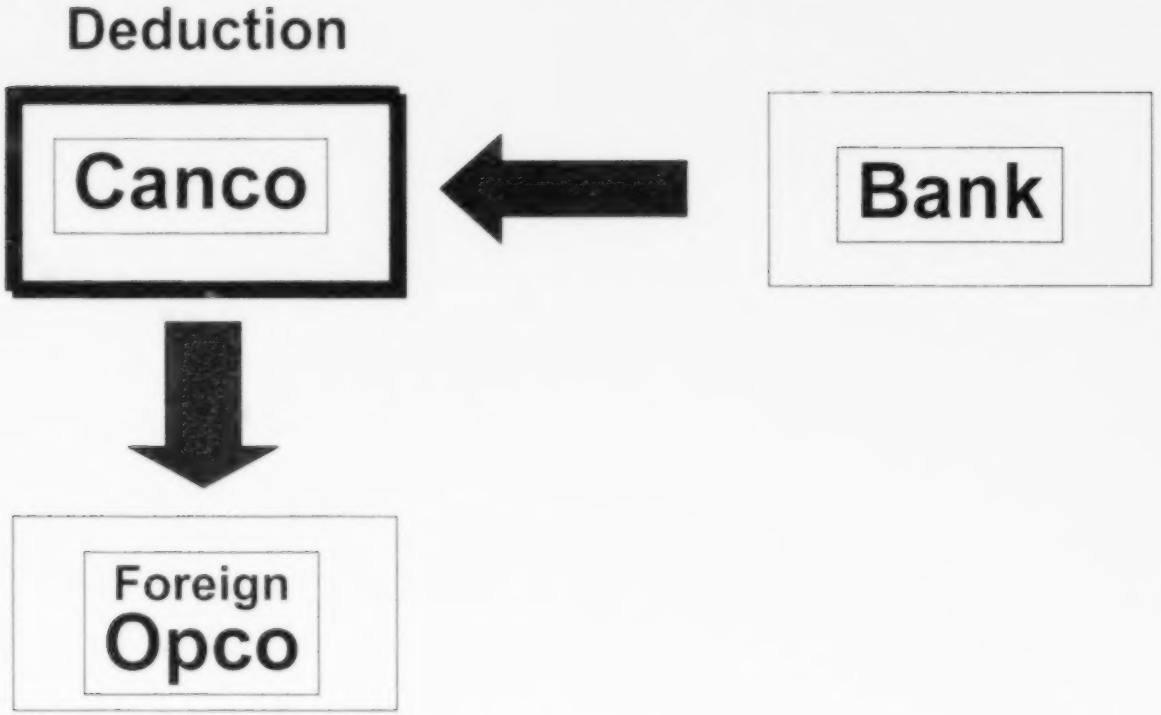
Concerns raised by Auditor General, 1997 Committee on Business Taxation and the Public Accounts and Finance Committees

1997 Committee on Business Taxation recommended restrictions

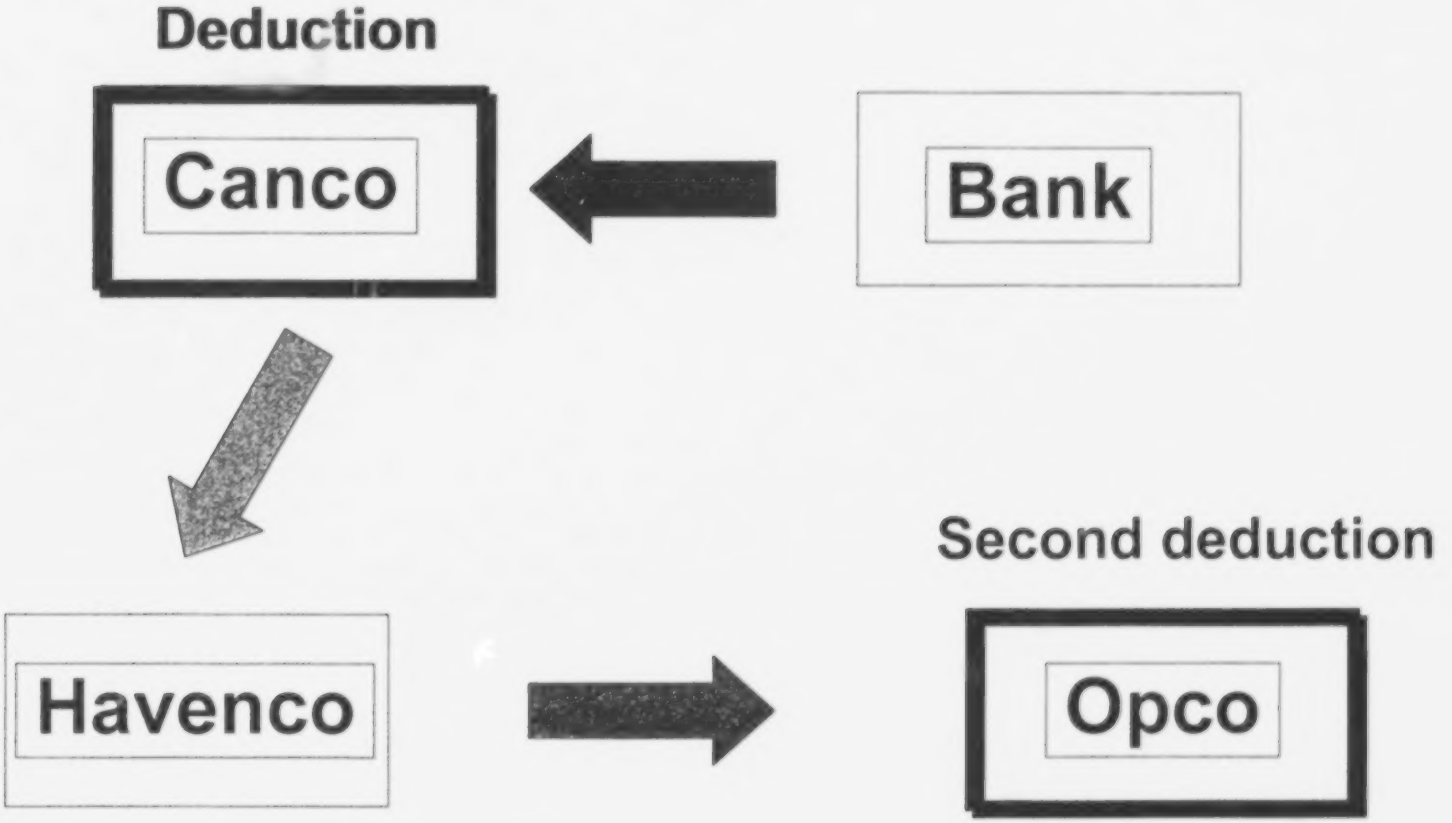
Anti-Tax Haven Initiative

- No double dips
- Five-year transition period
- Revenues generated will be used to reduce business taxes
- Advisory panel on international tax fairness and competitiveness

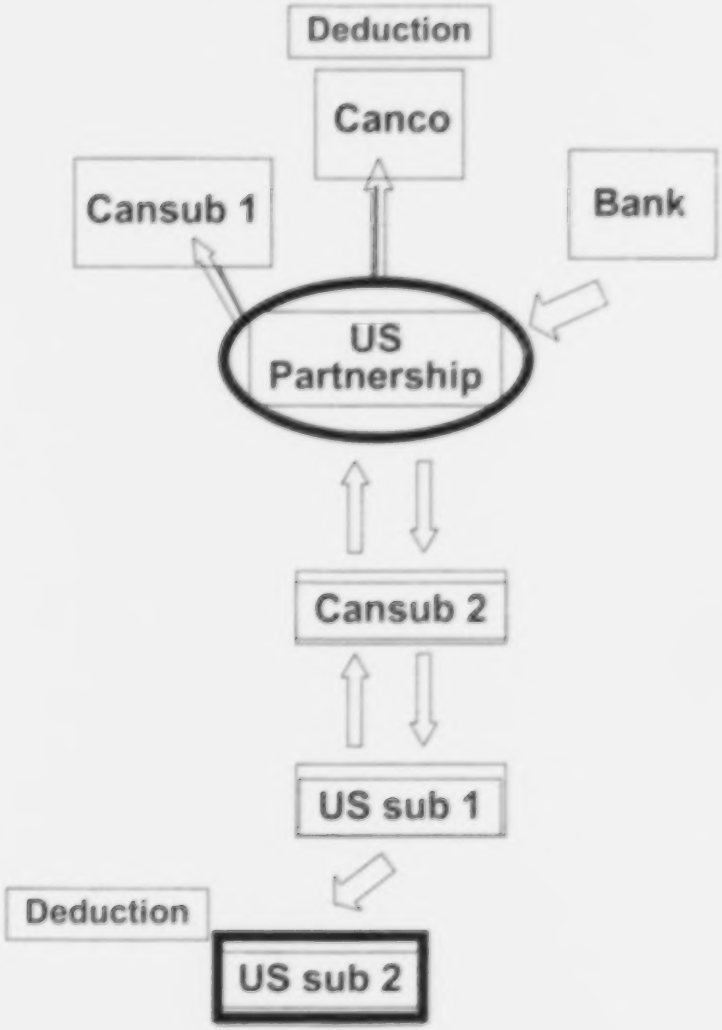
The "single dip"



The "double dip"



The “tower”


Deduction
Canco
Cansub 1
Bank
US Partnership
Cansub 2
US sub 1
Deduction
US sub 2

International tax competitiveness

Depends on:

- Marginal Effective Tax Rate
- Statutory tax rate
- Taxation of foreign-source income
- Interest deductibility

What other countries do

Some restrict double dipping

Some impose higher tax rates

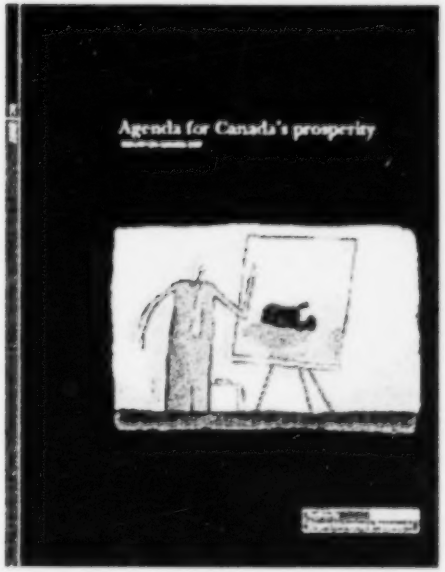
Some tax repatriated foreign earnings

Some restrict interest deductibility

Overall, Canada is competitive

Hollowing out?

Institute for Competitiveness & Prosperity



"Net, we simply are not being hollowed out. We are thickening up."

We are thickening up

Statistics Canada: Canadian investment abroad exceeds foreign investment here

Crosbie Investment Banking: Canadian acquisitions nearly quadruple foreign ones

KPMG: more Canadian acquisitions of foreign firms than foreign acquisitions of Canadian firms

A more competitive environment

What the Government is doing:

- Reducing corporate tax rate
- Eliminating corporate surtax
- Increasing threshold for small business tax rate
- Reducing small business rate

A more competitive environment

What the Government is doing:

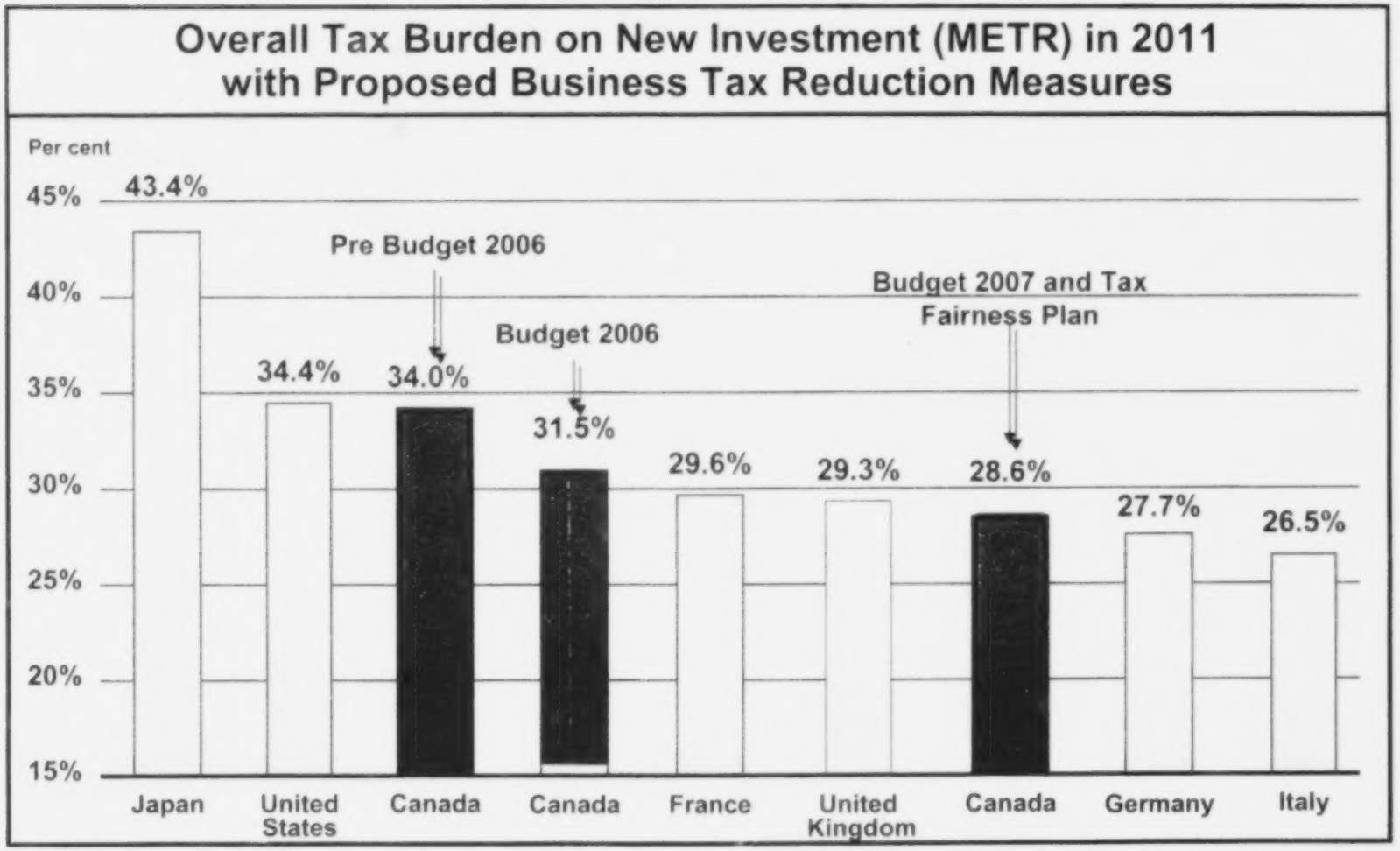
- Eliminated federal capital tax
- Providing incentives for provinces to eliminate capital taxes
- Better aligning CCA rates to useful life of assets
- Eliminating withholding taxes

Tax relief for Canadians

What the Government has done

- Reduced GST
- Introduced Canada Employment Credit
- Provided new Child Tax Credit
- Introduced Working Income Tax Benefit
- Introduced income-splitting for pensioners

Building a Canadian tax advantage



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